Financial crisis' chaos setting stage for bright ideas in money management

Firms find that advances made while digging out from global financial crisis are bearing new fruit

Money managers' unending quest to build a better mousetrap is drawing inspiration from the global financial crisis, with enhanced liquidity, more efficient beta and risk-focused dynamic asset allocation among the themes driving the latest rounds of innovation.

Some market veterans say managers particularly hard hit by the crisis could enjoy some of the more notable advances in coming years: “We're seeing a huge new wave of innovation in quantitative management,” as quant firms integrate investment practices they've honed over the years with risk management to produce “first-rate outcomes,” said Donald H. Putnam, San Francisco-based managing partner with investment bank Grail Partners LLC.

That marriage of previously developed techniques and risk-management architecture amounts to a “rebooting of quant,” after performance woes during the crisis bruised the reputations of a number of firms, Mr. Putnam argued. He cited Conquest Capital Group LLC, Cantab Capital Partners LLP, AlphaSimplex Group LLC, Windham Capital Management LLC and Ryan Labs Inc. as some of the quant firms doing interesting work now.

Opinions on the outlook for broader industry innovation are more mixed.

Some observers expect near-term progress to prove incremental, after investors who adopted newer strategies in the years leading up to 2007 — such as portable alpha — suffered badly when markets imploded.

With investors still licking their wounds, “the innovation boat is unlikely to be pushed out too far” over the next two or three years, concluded a June report commissioned by Principal Global Investors and Citigroup. Pension clients may well set higher hurdles when evaluating new products, with more stringent examinations of their risk-return profiles and insistence on “a strong overlay of human judgment,” the report said.

Not true

“I don't think the crisis is throwing up much in the way of true innovation” compared — for example — to how the introduction of derivatives set the stage for a decade or two of new approaches in constructing investment strategies, noted Andrew Kirton, Mercer LLC's London-based global chief investment officer, investments.

Still, the uncertainties clouding the outlook for mainstream assets such as bonds are prompting investors to think “laterally and broadly, and be more open to ideas than they were a number of years ago,” he said.

For example, investors have proven more willing to adapt tried and true ideas to new markets, Mr. Kirton said, pointing to the recent launch of “friendly” activist funds — as opposed to the arm-twisting variety — targeting investments in cash-rich midcap and small-cap Japanese companies.

Investors have likewise been looking at a growing number of private debt vehicles launched to fill the lending gap left by leverage-scarred banks, he said.

That interest is a sign of institutional investors being “much more nimble, trying to identify opportunities as they arise, even if they don't fit cleanly into traditional buckets” such as hedge funds or traditional private equity, said Erik Knutzen, CIO of investment consultant NEPC LLC in Cambridge, Mass.

Leo de Bever, CEO of Edmonton-based sovereign wealth fund Alberta Investment Management Corp., said that to earn above-market returns for the alpha portion of his C$68 billion (US$71 billion) fund, AIMCo's staff is increasingly getting into the “messy” work of seeking out niche opportunities that straddle traditional asset classes. As examples, he cited his team's pending investment in a Brazilian barge company being launched to fill a need in the local economy that wasn't being served, and a 25,000-hectare land purchase in Australia connected with a government-sponsored tree-planting program that had gone bankrupt and required a long workout period.

Some market veterans argue the recent crisis accelerated acceptance of previous rounds of innovation. The continued rise of non-cap-weighted indexes as a means of getting more efficient market exposure is one of a handful of trends driving change now, noted Ronald G. Layard-Liesching, founder of Bellevue, Wash.-based Mountain Pacific Group LLC.

Jason Hsu, chief investment officer of Newport Beach, Calif.-based Research Affiliates LLC, said investors' disappointment with the performance of their active managers in 2008 has helped stoke that interest, bringing alternatives to capitalization-weighted indexes — a sector his firm's “fundamental indexes” helped launch in 2004 — that much closer to the mainstream.

Those non-cap-weighted alternatives — for equity and increasingly for fixed-income indexes as well — are “really flooding the market,” reaching a critical mass that will lead to a “fundamental shift in the industry,” he argued.

Research Affiliates will introduce its own non-cap-weighted sovereign bond indexes later this year.

An alternative

In April, meanwhile, State Street Global Advisors launched an exchange-traded fund based on a non-cap-weighted alternative for corporate credit, the SPDR Barclays Capital Issuer Scored Corporate Bond index, which was based on research done by SSgA, said Kevin D. Anderson, the firm's London-based global chief investment officer for fixed income and currency.

While maintaining the sector weightings of market-cap weighted indexes, the CISC index screens potential constituents for inclusion, every six months, by criteria that include return on assets and interest coverage — leaving the top 10 issuers with 3.5% of the index, compared with 22% for the cap-weighted index. With the likely end of a decades-long credit rally looming, the need for investors to pay more attention to the “idiosyncratic” risks of corporate bond issuers prompted the firm's research efforts, Mr. Anderson said.

In addition to the rise of non-cap-weighted indexes, continued gains by “rules-based” investment strategies, such as ETFs, at the expense of active managers is another important trend, said Mr. Liesching. The most far-reaching changes, however, could result from the replacement of fixed asset allocation policy portfolios with more dynamic, risk-driven approaches, he said.

That risk-focused approach requires a commitment to find “meaningful definitions of asset classes,” noted Andre F. Perold, CIO of Boston-based outsourced CIO firm HighVista Strategies LLC. He called the use of private equity or hedge funds as asset allocation categories “complete nonsense,” on par with deciding to allocate a portion of one's portfolio to mutual funds.

However, defined, investors increasingly are looking for managers that can provide multiasset-class capabilities and have a “solutions-driven type of discussion,” noted Barbara McKenzie, chief operating officer with Principal Global Investors, Des Moines, Iowa.

Executives with a number of firms, when asked about their newer offerings, talked about such multiasset-class products.

Jeffrey Geller, a managing director with New York-based J.P. Morgan Asset Management and Americas CIO of its global multiasset group, said his firm is establishing credit partnerships with clients that will leave his team positioned to respond to dislocations as the environment evolves through a market cycle.

Within these relationships, the group can allocate opportunistically in an environment where opportunities often last too briefly for more traditional institutional investment processes to be effective.

Early last year in the U.S., Morgan Stanley Alternative Investment Partners, a division of Morgan Stanley Investment Management, began offering similar partnerships for the alternatives portion of institutional portfolios. A dynamic opportunity set in that market segment has buoyed demand for more active management of non-traditional allocations, noted Jacques Chappuis, a managing director and head of AIP.